Making M&A pay: lessons from the world's most successful acquirers

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Mergers and acquisitions activity waxes and wanes in cycles. The most recent wave, and the largest ever, peaked in 2000 with $3.5 trillion worth of announced deals. The following year, activity turned downward sharply, influenced by falling share prices, a weakening US economy, reports of vast goodwill write-offs, distressed disposals and high-profile integration failures. Now, as the global economy starts to perk up, interest in M&A is once again building.

Now is the time to confront the paradox at the heart of M&A. It is generally accepted that over the course of all business cycles, mergers and acquisitions play a key role in modernizing industries and increasing aggregate shareholder value. Yet study after study has shown that most deals destroy value for the acquirer's shareholders.

Research undertaken by Marakon Associates to explain this paradox reveals that, although many acquisitive companies do destroy shareholder value, some of the world's best-performing corporations are also unusually acquisitive. These companies have used M&A as a central pillar of their overall growth strategies, helping them achieve top-quartile shareholder returns in their industries.

Our study illuminates the decision biases of these top-performing acquirers. These biases will be vital to value creation in the next M&A wave, which we expect to be weighted toward Europe and perhaps Asia, as national and regional regulatory regimes are relaxed and cross-border opportunities dominate strategic thinking.

M&A – an enduring feature of the business landscape

Mergers and acquisitions have been an important strategic tool for well over a century. They tend to peak in waves when two catalysts are present: a major discontinuity in the business environment (caused, for example, by new technologies, new or rapidly growing markets or regulatory change) and the emergence of a new source of finance.

Rapidly expanding markets and plentiful bank financing led to the first great merger wave at the end of the 19th century, as Carnegie, Rockefeller and the Vanderbilts acquired industrial dominance through ''horizontal'' mergers. The antitrust legislation that followed combined with buoyant equity markets to inspire a wave of ''vertical'' mergers in the 1920s. In the 1950s and early 1960s, high-priced equity was the currency for a third post-war merger wave. High-yield junk bonds financed a fourth wave in the 1980s, triggered by a more lenient attitude toward M&A in competitive global industries and voracious demand for new products, such as computers and pharmaceuticals. New mass-market products such as mobile phones,

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converging technologies and de-regulation fueled the most recent wave from the mid-1990s until 2001.

Academic research has consistently shown that 50 percent to 75 percent of all M&A activity destroys value for the acquirer’s shareholders. So why have so many CEOs persisted over so many years with such a risky strategy?

There are two reasons for this triumph of hope over experience. First, as is widely acknowledged, it is easy to get carried away by the adrenaline rush of M&A, particularly when M&A waves overwhelm industries. Caught up in the excitement of deal making and urged on by advisers who say they must buy or be bought, acquirers select the wrong targets, overpay and become so distracted by post-deal integration that they neglect their pre-existing businesses. Chief executive ego and excessive self-confidence often play a role.

Consider this observation by Warren Buffett, chairman of Berkshire Hathaway:

> Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad’s body by a kiss from a beautiful princess . . . Absent that rosy view, why else should the shareholders of Company A(cquisitor) want to own an interest in [Company] T at the 2× takeover cost rather than at the X market price they would pay if they made direct purchases on their own? In other words, investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toad, those kisses had better pack some real dynamite. We’ve observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses.

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This statement rings as true today as it did two decades ago, when Buffett delivered it in his 1981 letter to shareholders. In fact, several studies statistically link CEO hubris to overpaying and value-destroying acquisitions[1]. A classic example can be found in the record of Ed Crutchfield, who during his 17-year tenure as chairman and CEO of First Union Corp. acquired more than 70 banks. At the height of First Union’s rivalry with its Charlotte, North Carolina neighbor, NationsBank[2], Crutchfield paid a record-breaking $17 billion (5.3 times book value) for CoreStates Financial of Philadelphia in November 1997 – just three months after NationsBank announced plans to buy Barnett Bank of Jacksonville, Florida for $15 billion (4 times book). CoreStates, however, was a far less desirable prize for First Union. Already well managed, it was in a low-growth geographic area and promised few revenue and cost synergies. The result: the CoreStates acquisition destroyed several billion dollars of value for First Union shareholders. Commenting on one of his many deals, Crutchfield once boasted, ‘‘I just kept stacking billion-dollar bills on the table’’ until the other side relented[4]. Not surprisingly, news of his resignation as CEO on March 10, 2000 caused First Union shares to jump 5.6 percent on a generally down day for bank stocks.

The second reason why hope trumps experience when it comes to M&A is that M&A actually can create substantial value for an acquirer’s shareholders. Our research shows that a number of the world’s top-performing companies are unusually acquisitive. We term these companies ‘‘acquisitive exemplars’’, and we believe M&A’s reputation as a value-creating device can be redeemed if other companies learn from them[3].

Profiling the acquisitive exemplars

Our experience with clients suggests that the principal problem with M&A is not that acquisitions inevitably destroy value for the acquirer’s shareholders, but that most acquirers either do not know or violate certain fundamental rules for value-creating M&A-led growth.

Our research confirms this belief. It indicates that M&A-led strategies can be value creating in any industry and that in some industries, M&A can be a *sine qua non* of profitable growth. But you have to do it right (see box, ''Five steps in evaluating M&A transactions'', for a value-focused approach to M&A).

Rather than examine transactions (the traditional focus of M&A studies), we focused on companies and their growth strategies, which, in some cases, were driven by serial acquisitions. The study set out to answer two questions:

(1) How many, if any, top shareholder value performers are unusually acquisitive?

(2) What distinguishes these exemplars and their strategies from acquisitive companies that under-perform?

Our study confirms the well-known statistic that more than 50 percent of acquisitions destroy value for the acquiring company's shareholders during the announcement period, but also identifies long-term exemplar performers, with strategies that rely heavily on M&A.

The study found that approximately 50 percent of all exemplars (top-quartile TSR performers in their industries) are acquisitive (see Figure 1). In mature industries, well over 50 percent of exemplars are acquisitive, and bottom-quartile TSR performers are more likely to be non-acquisitive (see Figures 2a and 2b).

In many cases these successful acquirers have persuaded the market to reverse its short-term bias against M&A (see box, ''Earning the market's admiration'').

These 10 ''acquisitive exemplars'' beat the short-term odds between 1996 and 2001 by explaining their strategies and M&A plans to the market effectively enough to record increases in relative TSR at the time they announced their deals. Others had to announce improved results

Five steps in evaluating M&A transactions

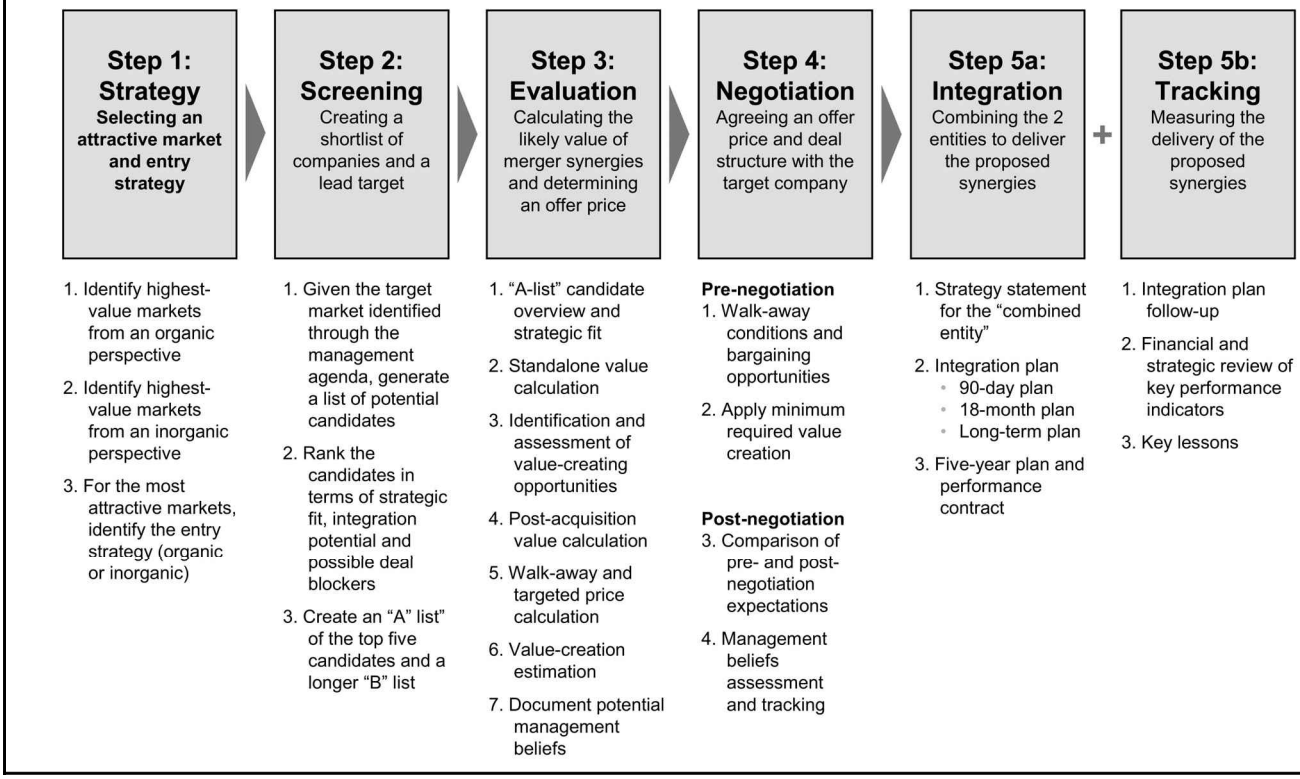


Figure 1

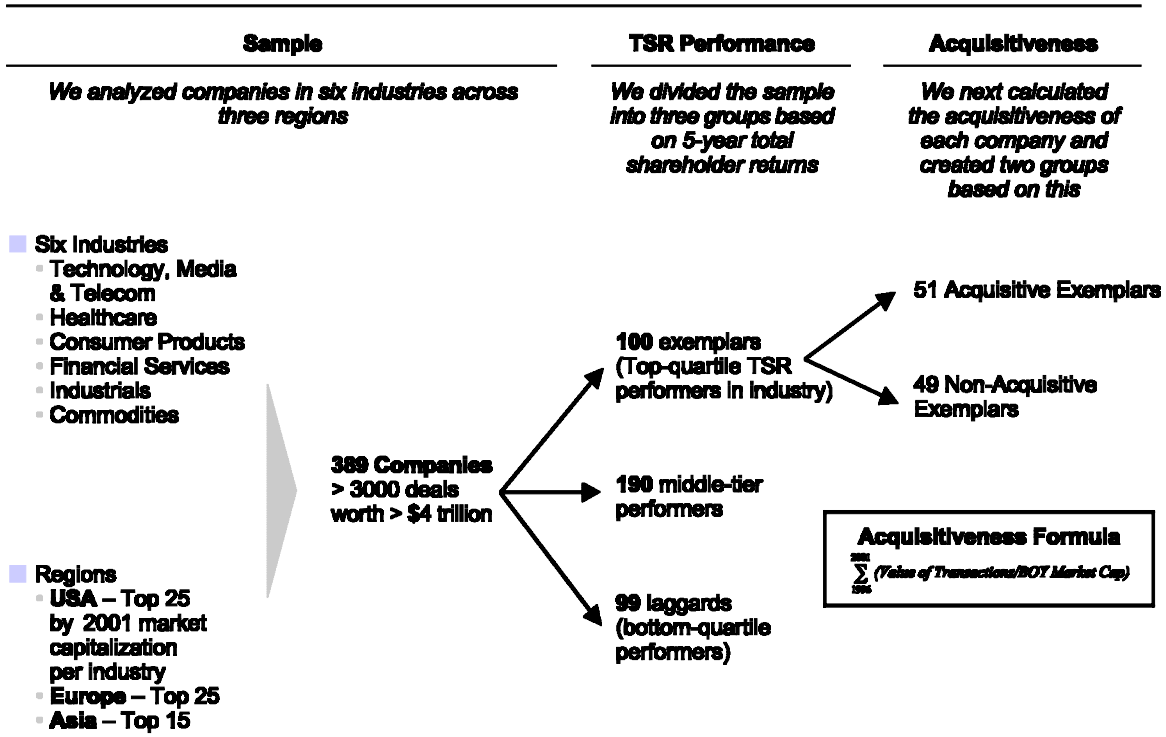
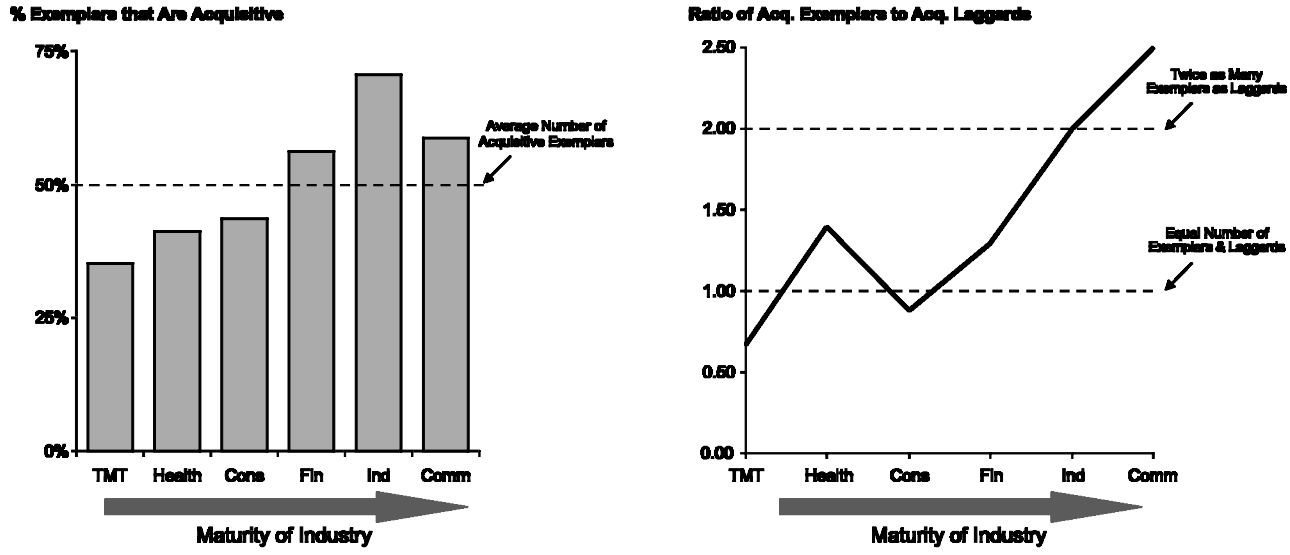


Figure 2



before receiving their market accolades, but they too beat the long-term odds by generating top-quartile performance over the five-year period.

Learning from acquisitive exemplars

Our analysis reveals that acquisitive exemplars have two types of decision biases – general and industry-specific.

Earning the market's admiration

Some companies have built such an impressive track record of acquisitions success that the market reacts favorably to news of new activity. Below are examples of acquisitive exemplars that recorded increases in relative TSR at the time they announced their deals:

- BNP
- Comcast
- Renault
- Alcoa
- General Dynamics

General decision biases

The companies that emerge as acquisitive exemplars from our study all share three characteristics:

(1) Disciplined management processes: they develop management processes that allow them to extract value routinely from acquisitions (e.g. Alcoa, BP).

(2) Disciplined link to strategy and company strengths: they are exceptional at making the most of their competencies and strategic assets – (a) they have a particular appetite for assets that allow them to distribute existing products to new customers (e.g. Nestlé), and (b) they only buy new products when they already possess the channels needed to distribute them (e.g. Unilever, Shire).

(3) Exceptional, industry-specific M&A capabilities: they create competitive advantage in M&A by developing capabilities, such as target selection, bidding/negotiating or integration, that extract value from deals in their own industries (see below).

These attributes indicate that acquisitive exemplars view M&A as a means to a strategic end, rather than an end in itself.

Industry-specific biases

Our study suggests that these general biases, though they can have a pronounced effect, are not sufficient for success in mergers and acquisitions. Other biases dictated by the maturity and current circumstances of their particular industries are also followed by acquisitive exemplars, and they vary significantly from industry to industry.

"Mature" industries

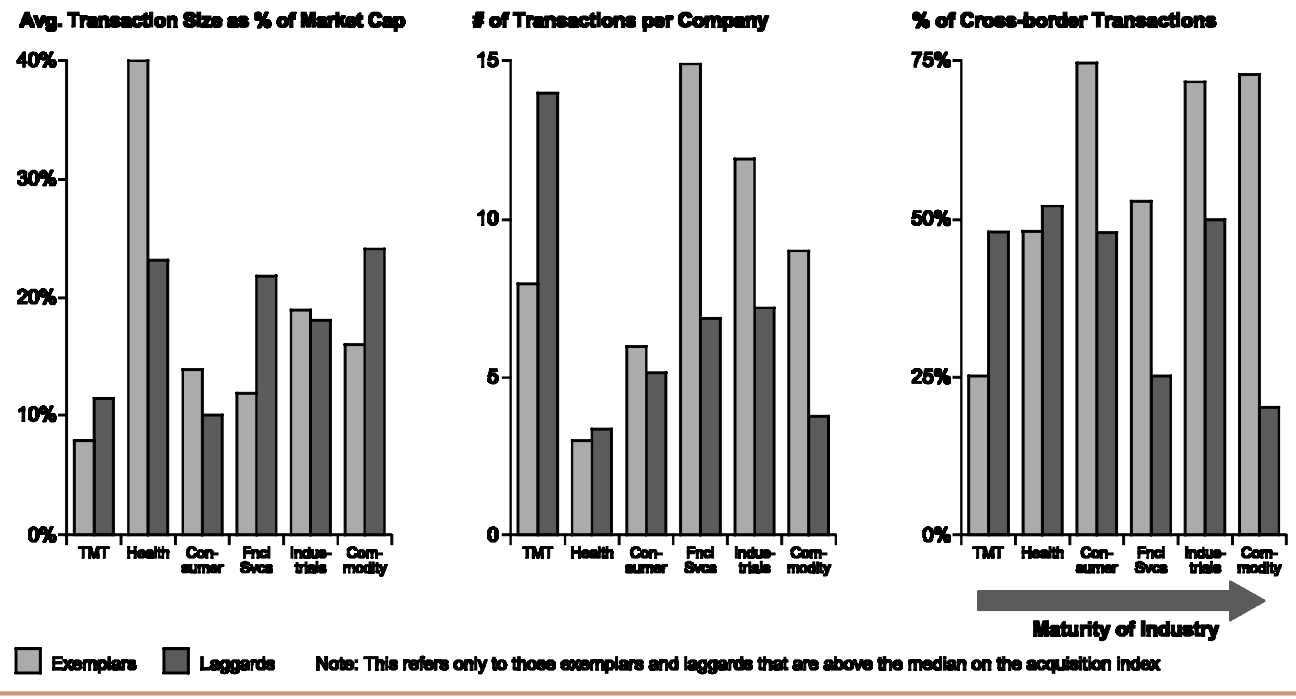
In relatively stable industries such as financial services, traditional manufacturing and basic materials (e.g. chemicals, metals and mining), acquisitive exemplars have three basic M&A biases: buy small, buy often and buy cross-border (see Figures 3a-c).

The competitive advantages of acquisitive exemplars in these industries are exceptional integration skills and the ability to negotiate good prices for appropriate targets. Buying small makes integration easier and reduces a company's exposure to the risks associated with overpayment and integration failures. Buying often moves companies down the negotiation and integration learning curves (see Appendix 1).

Consumer products are a unique category of mature industry. The acquisitive exemplars in these brand-driven sectors follow the same rules as their counterparts in other mature

> **"We believe M&A's reputation as a value-creating device can be redeemed if other companies learn from the 'acquisitive exemplars'."**

Figure 3



industries, but they display a particular appetite for cross-border deals (see Figure 3c) that offer opportunities to exploit skills and assets acquired in domestic markets. The deals typically add to brand portfolios or extend their distribution networks to leverage the existing brand (see Appendix 2).

''Turbulent'' industries

In volatile industries such as technology, media and telecommunications, rapid technological change or deregulation is causing a radical restructuring. As a result, companies have great difficulty predicting the impact of technological changes and valuing intangibles, such as intellectual capital. This is reflected in the high variability of acquisition premiums (see Figure 4). Acquisitive exemplars are relatively rare in these ''chaotic'' industries because of the difficulty in judging the right price and because organic opportunities are plentiful and generally create more value. But acquisitive exemplars exist even in these industries and are exceptional at target selection (e.g. Comcast).

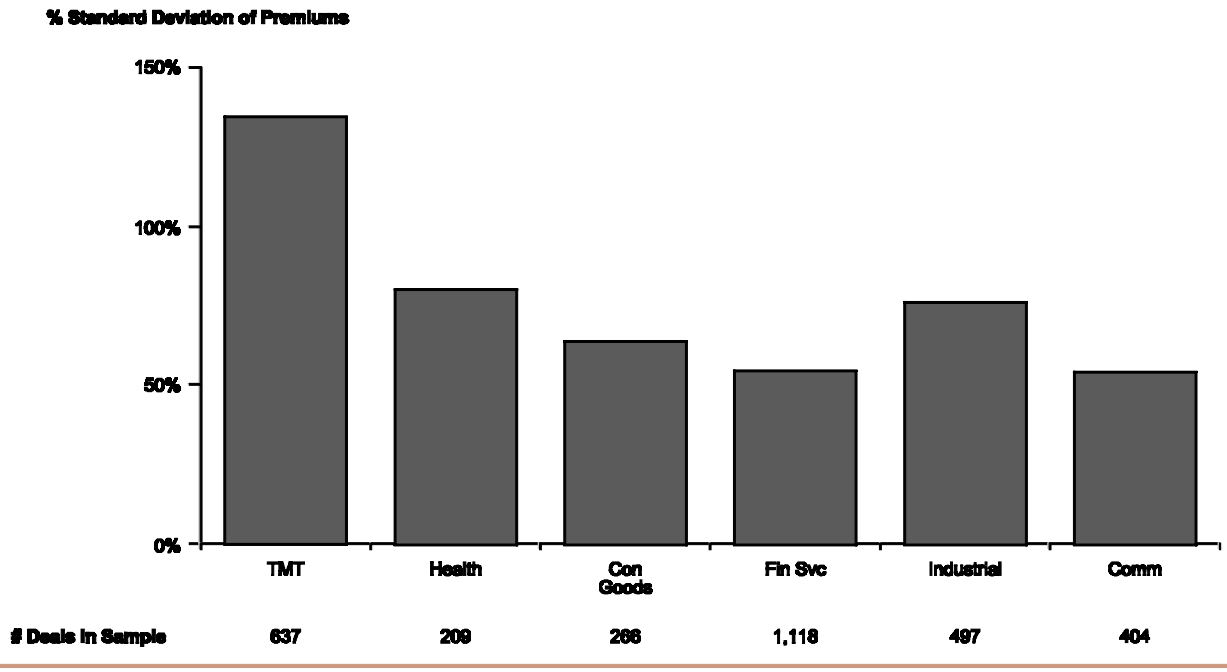
In general we have observed five decision biases for acquisitive exemplars:

(1) Set the balance between organic and M&A-led growth in your corporate agenda, according to the maturity and dynamics of your industry. Exemplars are particularly active in mature industries and inactive in less mature industries. If you're in a mature industry like industrial manufacturing and don't have M&A on your corporate agenda, you probably should. And if you're in a newer industry like telecom, set very high standards for potential M&A opportunities.

(2) Favor organic or acquisition-led growth in specific businesses in your portfolio (i.e. do your businesses have the right strategic agenda?). Depending on the business unit's industry segment, M&A could be a distraction or it could be a necessity. Challenge the level of acquisitiveness in your business unit's agendas, and make sure they are aligned with the dynamics of the industry.

(3) If the growth strategy needs to be biased toward acquisition, challenge your business at both corporate and business unit level on the nature of these acquisitions (e.g. size, nature

Figure 4



of synergies, cross-border or not). Many executives sanction business unit acquisitions without asking basic questions (e.g. ''What else did you consider? Why so big?'').

(4) Develop the key M&A capabilities needed for success in your industry or market segment. If M&A offers the potential for competitive advantage in your industry, then building those capabilities should be a top priority. If it doesn't, don't over-invest in exploring deals; allocate time, talent and money elsewhere.

(5) Develop a fully accountable process and appoint fully accountable people to integrate your M&A decisions with strategy formulation and performance monitoring (see box, ''A CEO's checklist for making M&A pay''). This will involve agreeing on a shared ambition (e.g. doubling intrinsic company value within four years), managing to a shared strategic agenda

A CEO's checklist for making M&A pay

For CEOs of large companies, the following checklist of questions can serve as a guide for helping ensure that economics and organizational discipline triumph over ego and emotion:

- Is our walk-away price based on the value of the seller to us, or is it based more on an average industry premium?
- Is my management team committed to walking away if the ''ask'' price is above our walk-away price?
- Does the integration team own the numbers (e.g. synergy valuations)?
- Does clarity exist around the ''high-value opportunities'' that we should pursue?
- Do we have sufficient specificity around what needs to be done to capture the high-value opportunities?
- Does clear management accountability exist for delivering the high-value opportunities?
- Do we have commitment from both management teams to change (versus resistance to change)?
- Do the two management teams agree on a shared definition of success?
- Is there agreement on the best metric(s) for measuring performance?
- What is the process for agreeing and resolving the high-value opportunities in the future?

of the highest value-at-stake issues and opportunities, demanding shared learning by the executive team and building a shared sense of how to run the business (e.g. a common set of decision-making principles and a common performance orientation that gives managers clarity around nagging rights)[4].

These five biases complement the two well-known, but often ignored, rules:

(1) mergers and acquisitions are a means to implementing a strategy, not a strategy in themselves; and

(2) each acquisition should be value-creating as part of the strategy it implements and in most cases on a stand-alone basis.

Conclusion

As regulatory changes in Europe prepare the ground for a new M&A wave, our study challenges the anti-M&A bias created by the media's tendency to judge the takeover system by the performance of an average (and in some cases the worst) acquirer. It shows that every industry has acquisitive exemplars and describes how they extract value from acquisitions for their shareholders. As the next big M&A wave approaches, CEOs and their corporate development teams would do well to learn from these companies if they are to avoid the mistakes that have destroyed so much value for shareholders and marred the reputation of M&A.

Notes

1. One noteworthy example is Mathew L. Hayward and Donald C. Hambrick's ''Explaining the premiums paid for large acquisitions: evidence of CEO Hubris'', *Administrative Science Quarterly*, March 1997.
2. NationsBank was renamed Bank of America in December 1998, after it and BankAmerica announced plans to merge in April of that year.
3. While we have identified acquisitive exemplars, we cannot say that acquisitiveness drives top-quartile TSR performance or that the acquisitive laggards are so because of their acquisitiveness. However, our study points to two reasons why acquisitiveness is strongly linked to superior performance: (1) the size of the transactions and level of M&A activity make the deals among the most significant decisions that management made during the period of observation; and (2) While the majority of deals destroyed value for acquisitive laggards, the majority of M&A deals completed by acquisitive exemplars created around the time of announcement.
4. For an elaboration on these ideas, see ''A merger of minds: building organizational advantage through shared leadership'', *Marakon Commentary*, Vol. V No. 1, 1999.

Appendix 1. Alcoa: an acquisitive exemplar in a ''mature'' industry

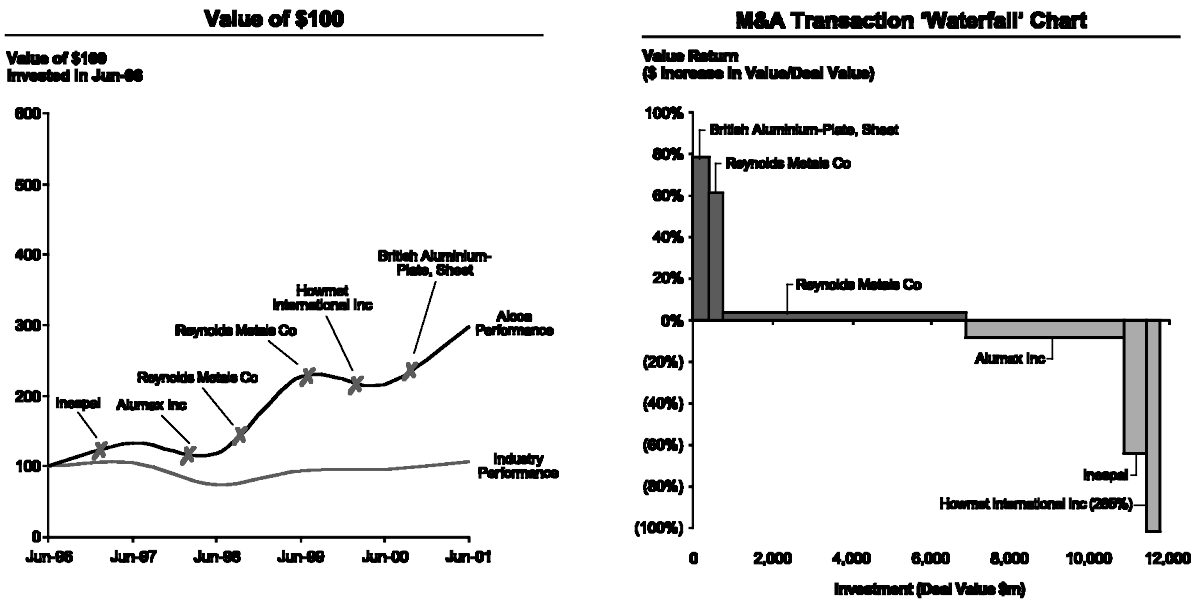
Alcoa's performance in recent years clearly demonstrates that well-executed acquisition programs can be powerful value creators in stable, supposedly ''mature'' industries, such as aluminum production. With its stated strategy of strengthening its global position through acquisitions and joint ventures, the company achieved a total shareholder return of 24.4 percent (annualized) in the five years ended June 2001. In the 10 years ended June 2003, it delivered a TSR of 13.4 percent vs. 2.1 percent for global industry peers.

Much of this expansion was in Europe, where the market was less mature than in the USA and ''very underdeveloped'', according to former CEO Paul H. O'Neill.

The market did not welcome Alcoa's first two major acquisitions during the period, and the stock fell after the announcements. But with the exception of the Howmet acquisition, subsequent deals were met with very positive responses. There seem to have been two reasons for the negative reaction to Howmet. It came

"Alcoa's performance in recent years clearly demonstrates that well-executed acquisition programs can be powerful value creators in stable, supposedly 'mature' industries, such as aluminum production."

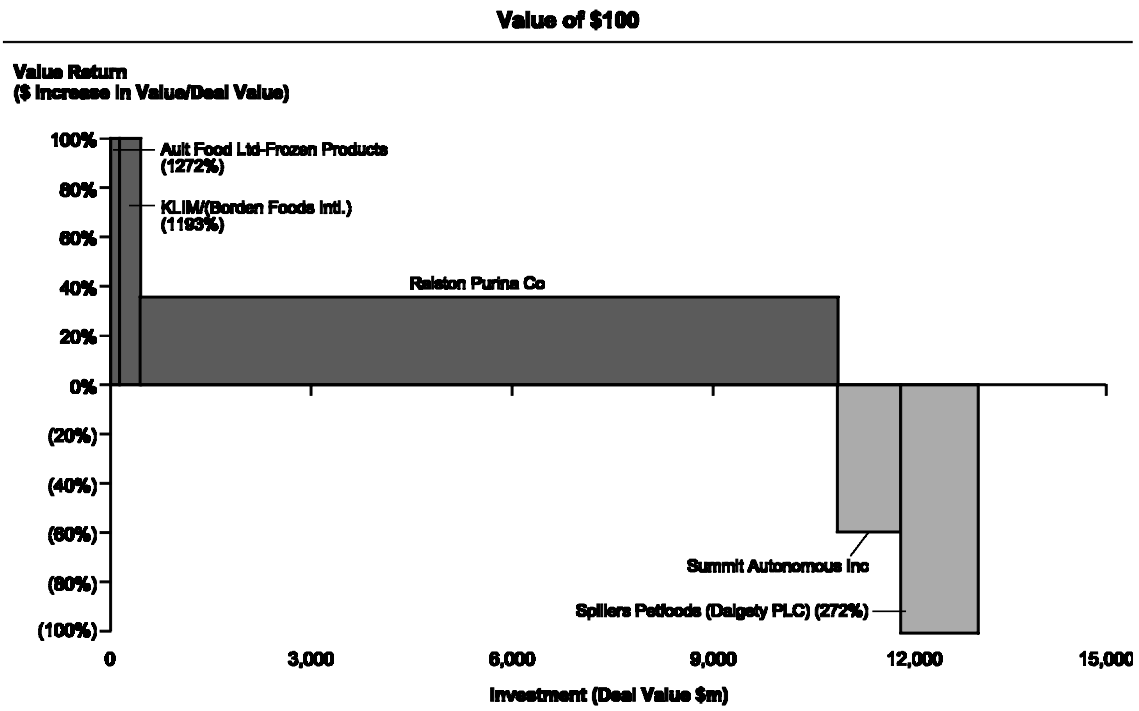
Figure A1



so soon after the other deals that analysts had no time to digest what was happening, and Alcoa failed to remind the market of its strategy and integration skills.

Alcoa's success as an acquirer can be largely attributed to rigidly applied target selection rules and a disciplined integration process. It looks for deals with good strategic fit, allowing the company to leverage its know-how in engineered materials. It is also only interested in deals that offer significant cost synergy opportunities in procurement (e.g. sharing of best practices and redundancy elimination).

Figure A2



The company integrates people and processes quickly, and makes performance (not winning a bid) its key focus. As a result, Alcoa's 1998 acquisition of Alumax added to its top and bottom line in the first quarter of integration. Although aluminum prices plunged by 20 percent in 1998, Alcoa sales and net profit finished the year up 15 percent and 6 percent, respectively.

Because Alcoa knows that ''doing the right deal'' is only half the battle, it maintains a permanent team of managers specializing in rapid integration of acquisitions, and requires each acquisition to deliver synergies within one year.

Appendix 2. Nestlé: strong performance in consumer products

In the five years ended June 2001, Nestlé, the Swiss consumer goods giant, completed five major acquisitions and achieved a total shareholder return of 23.4 percent (annualized). In the ten years ended June 2003, Nestlé delivered a TSR of 11.3 percent vs. 7.5 percent for global industry peers.

The market has generally welcomed Nestlé's deals because the company has a clear and well-understood acquisition strategy, chooses targets with strong management teams increasing the chances of synergy capture and has a reputation for efficient, post-deal integration. Target selection is both opportunistic and disciplined. Targets have to fit well strategically, have strong management teams, provide new distribution networks, new products or new product/service combinations, or deliver new R&D capabilities.

Nestlé does not have a reputation for getting the best price (it is thought to have paid relatively high premiums for Ralston and Spillers), but it has taken care to explain its strategy clearly to the market. Cyrill Moser of UBS Warburg in Zurich said that the Ralston acquisition was ''certainly not a bargain'', but had ''high commercial logic'', with Ralston Purina's strength in ''dry'' dog food complementing Nestlé's leading Friskies pet-food brand.

Nestlé's reputation for managing integration well stems from its tendency to let target management teams run merged divisions, rather than insisting that its own people take over (as in the Ralston case). Annual cost savings of $260 million are expected from the Ralston deal from 2003 onwards, and significant cost synergies in areas such as logistics and purchasing are expected from the Spillers deal.